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Dominion Energy Inc

Poised to Heat Up this Summer

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Busy month ahead for shares- but will it work?

We note a fast paced summer for Dominion approaches, with developments on Millstone nuclear slated for as soon as next Wednesday June 7 with the end of the CT legislative session (we remain a bit cautious given the tight vote in the Appropriations committee). Further, we see ACP in mid-July, a likely positive in moving forward, but more importantly followed by a September update on additional capex. This last piece is likely the element driving confidence in recent weeks, particularly when coupled with continued DPS growth confidence. We remain more cautiously positioned on shares here, but appreciate EPS revisions may indeed skew higher in the near-term.

Capex update this Fall could include a few more items to keep budget aloft

We see mgmt as poised to provide details on its nascent pumped hydro efforts in VA as well as delineate more formally its nuclear relicensing capex (upwards of ~$ Bn over ~10-years). While some extent of this and energy capex is already disclosed, confidence appears on maintaining the $3.5 Bn spend pace. We believe the added granularity on nuclear as well as some development on a new series of Pumped Hydro facilities should bolster the core utility spend further, with all of this being recoverable outside of base rates through legislatively approved riders. Also, in tandem with EPS will be DPS growth

Hearings at Supreme Court on Biennial Review are the Key Summer Risk

While mgmt. appears quite confident, this is our most substantial concern through the near-term with a decision on the legality of the Biennial review process freeze ongoing. We emphasize the process back to a typical biennial ROE review process is unclear should the courts overturn the current freeze, potentially delaying any EPS impacts for several years still. Nevertheless, this would interject substantial uncertainty into future VEPCO EPS and could jeopardize the company's premium P/E multiple.

Valuation: Reaffirm caution on datapoints. Increase SoTP PT from $75 to $79

Despite the continued relative rally in shares, we see our $79 PT, as largely reflecting a group P/E multiple as well as largely putting a P/E multiple on any potential associated utility debt. Further, we note the disconnect in midstream valuations vs. utilities as a more cautious backdrop. While mgmt. is admittedly poised to increase spend on the utility side of the house, we perceive more limited latitude on spend at Dom-Energy.

How do we view the shares overall?

We remain cautious on the shares given the potentially delicate schedule ahead and particularly after the recent share rally. We believe the main source of upside resides in mgmt.'s ability to deliver on its CapEx plan, principally refocusing on its core regulated utility growth prospects. With shares having recovered substantially since the 4Q guide down, we see D as once more at the highest P/E multiple stock in the sector despite its near-sector high leverage. We view this combination cautiously despite prospects for modest incremental EPS growth later in the year, as this will simply backstop the existing EPS commitments. Further, we note incremental energy projects appear to be already reflected in placeholder Energy capex already disclosed, making incremental updates less decisive to existing estimates. We note rotation back into the Infrastructure theme of late given challenges elsewhere to higher growth utilities, principally California, and see Dominion as a recent beneficiary of this trend as well as NextEra. We expect shares to see volatility return this summer as key debates are resolved, with a more cautionary skew given recent outperformance.

VA Supreme Court update: What to Watch?

SB 1349 in Virginia which aims to prohibit prudency reviews by regulators of ratepayer charges by Dominion Virginia Power while also freezing base rates through 2019 is being challenged at the Virginia Supreme court. Opposition has taken issue with the ability for D to utilize rate adjustment clauses while simultaneously keeping base rates frozen. We note the recent hearings have largely debated whether or not the legislature has authority to remove the Commissions power and duty to regulate electric rates and to set rates themselves. Further focus stems on the court's interpretation of Article 9, Section 2 of Virginia law. The commission ordered testimony pointing out that a four year freeze of base rates set by the Commission could be considered a requirement under Article 9. We note base rates, as are, would stay frozen until 2019, with a need to trigger two subsequent biennial test periods in order to have rates reset (pushing out the reset well into the 2020's earliest). It remains unclear just how new rates would be implemented if interveners are successful. We caution that earned ROEs appear to be in excess of the authorized levels. Net-net, we see this as a generally cautious near-term datapoint given limited negative outcome embedded in investor expectations.

Scaling up Capex Further?

The question is just how far mgmt. can execute on its total capex plan. We emphasize that mgmt. is keen to maintain at least $3.5 Bn in capex annually, and could well scale this further.

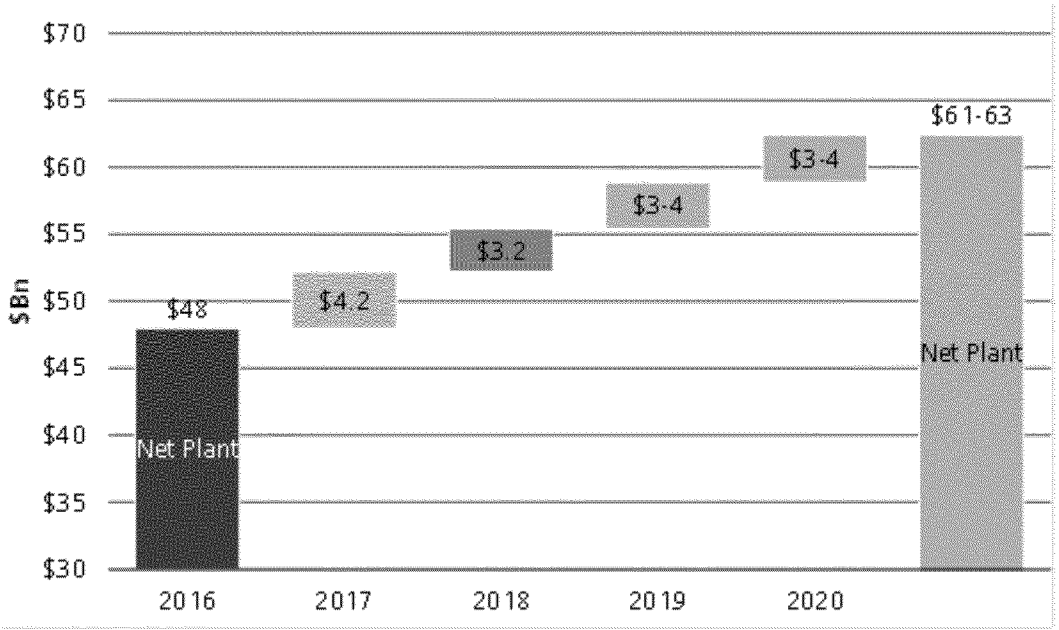
Utility: Pumped Hydro is a real opportunity

Mgmt. stresses it is evaluating what proposals to move forward with after having been engaged by entities across South-western VA to encourage economic development. While the size of any facility or *facilities* (plural) is likely only 200 MWs+, it is unlikely to compare to the other similar facility (Bath county at 2.4 GWs gross). We note that capex on selected sites could be more modest than greenfield pumped storage given existing caverns in mountains. We look for a more firm proposal in coming months, likely in tandem with usual ~Early September update. Any spend here would also be eligible for its generation rider treatment.

Nuclear reinvestment capital: getting more granular

We note that the precise cadence of its nuclear reinvestment program to extend the licenses of its four regulated units to 80-years from 60-years is uncleared. We look for more precise spending with this plan, with the total at ~$4 Bn over a 10+year period. We suspect this could add ~$200 Mn+ to even the near-year periods as work on reinvesting in the units ramps up. We note prior updates had not seemingly explicitly included this given the lack of clarity on whether this would be recovered under a rider treatment (clarified in the legislature) given its base rate stayout.

Figure 1: Capex Additions – Can it Keep it Going?



Source: FactSet

ACP FERC EIS approval: Around the Corner in July

We look for the FERC EIS to come in the ~July 19th timeframe. We further note the first round of extension (from 1.5 to 2.0 Bcf/d) could be achieved only with compression, i.e. without the need for additional laterals. While the exact amount remains to be defined (the exit points chosen determine the amount of compression needed, and thus the cost of the extension), mgmt. sees significant growth potential given the size of the project. We note this is already fully baked into the $3-4 Bn of annual CapEx in 2019/2020.

Could we get more gas midstream capex?

We note clear continued demand for additional spend with recent meetings pointing to greater detail in the coming months around the source of incremental growth within the Dom Energy segment, with specific focus on incremental pipeline opportunities. The question is the extent to which pipelines are expanded, compressor capacity location and ultimate delivery location substantially impact the outlook. We note that the latest discussions aside long distance pipelines remain on new power generation interconnection in Marcellus with many involving laterals to the existing network worth ~$10's of Mns. Broadly, assuming a higher return on the ~40% equity investment in the $1-2 Bn of incremental capital to be defined we see ~$0.10-0.20 of EPS opportunity yet to be funded in the later portion of the five-year program.

What about the Integrated Resource Plan (IRP)? More solar on deck

Recent mgmt. meetings have noted additional appetite for Solar in VA given costs have come down enough that planning models are now picking Solar over Gas. We note the latest IRP reflects growth in solar of 3,200 MW with costs projected at ~$50/MWh net of both REC value and the 10% ITC value back to customers. We emphasize the full extent of these efforts even with a steped down 10% ITC is unclear if it reflected in the capex budget – and provides support to a longer-term capex opportunity at VEPCO.

Update on Millstone: Will it succeed in the next week?

We look for whether mgmt. will succeed in coming week into June 7th expiration of the current legislative session. Shares could prove mixed into an update either way. While shares passed with some degree of support in the Joint state House & Senate Energy committee, the latest narrow passage out of the Appropriations committee by just one vote (and with the Chair labelling it as clearly a 'work in progress') bodes cautiously into this limited window for success. While we don't reflect this in our EPS estimates still, we note expectations had been dramatically higher on this prospect earlier.

What about more acquisitions?

We expect D to expand its DM subsidiary *without* dropping the coveted Cove Point assets in 2018. We believe there could be a desire to leverage the DM currency to acquire third party assets for a third time, avoiding a drop from the D parent. The latest example is the acquisition of STR and in turn the drop-down of the STR midstream portfolio, and before this its acquisition of SCANA's midstream portfolio. We see this as preserving the earnings power of Cove Point through the slower growth period at the Energy segment, while still accruing the benefits of any GP growth from acquisitions back to D.

Finally, should mgmt. drop down the Cove Point asset into DM in 2018, we note its previous commitment of three instalments does not necessarily state it would be ratable. We see this as being marketed determined and potentially smaller upfront, again, to preserve EPS at the parent.

Finally, what does this all sum up to? DPS Growth

The question is just where mgmt. will pivot its DPS policy as it seeks to preserve the 'best in class' commitment from last Fall. We include below our latest EPS and DPS estimates noting the implied Payout ratio at the higher end of peers.

Figure 2: Updated EPS Estimates

Dominion EPS by Segment	2014A	2015A	2016A	2017E	2018E	2019E	2020E	2021E
Dominion Virginia Power	0.86	0.83	0.78	0.93	1.08	1.13	1.16	1.26
Dominion Energy (incl STR)	1.29	1.10	1.14	1.33	1.63	1.86	2.00	2.09
Dominion Generation	1.88	1.89	2.26	1.67	1.75	1.73	1.58	1.58
Corporate (incl. Minority & HoldCo I	(0.60)	(0.38)	(0.39)	(0.33)	(0.53)	(0.41)	(0.35)	(0.49)
GP			0.00	0.03	0.07	0.12	0.19	0.35
Total UBS EPS Estimate	3.43	3.44	3.80	3.63	4.00	4.42	4.58	4.79
EPS Growth Rate				-4.5%	10.2%	10.5%	3.5%	4.6%
UBSe (Prior)	3.43	3.44	3.80	3.63	3.97	4.35	4.49	
Consensus as of 5/31/17				3.64	4.04	4.26	4.51	
Mgmt Guidance								
6% EPS Growth				2017 Midpoint	3.87	4.10	4.35	4.61
8% EPS Growth				3.65	3.94	4.26	4.60	4.97
				6-8% EPS CAGR in 2017-2020				
DPS (UBSe)	2.40	2.59	2.80	3.05	3.33	3.63	3.95	4.27
Payout Ratio	70.0%	75.4%	73.6%	84.0%	83.1%	82.0%	86.3%	89.1%
DPS Increase	6.7%	7.9%	8.1%	9.0%	9.0%	9.0%	9.0%	8.0%
Consensus DPS				3.02	3.29	3.57		
Consensus Payout Ratio				83.0%	81.4%	83.8%		

Source: Company Filings, FactSet, UBSe

Update on PJM auction results: net-neutral now to capacity price shifts

We see the PJM results as a modest impact on Dominion overall. While the company will be slightly net long on capacity once the Greensville CCGT reaches COD, with demand and load roughly similar the net impact will be roughly neutral. We emphasize capacity is recovered through base rates, i.e. rate cases (we note the company is currently under a rate freeze) and not under the fuel rider which could therefore cause an insignificant earnings lag.

Updated Valuation: Increase PT to $79

We include below our updated SOTP, maintaining our Neutral rating albeit with our price target below current shares. We increase our price target by $4 to $79/Sh; main factors contributing to the increase in PT include:

- Marking to market our commodity assumptions to reflect the latest power and gas forward curves: ~**$0.50/Sh**

- Marking to market our peer P/E multiple from 17.1x to 17.8x: ~**$2.50/Sh**

- Including $400 Mn of CapEx at VEPCO related to pumped hydro: **~$1.00/Sh**

Figure 3: Updated Valuation – Moving PT to $79

Dominion (D) Sum of the Parts Analysis - UBSe						
	2020E Adj. EBITDA	EV/EBITDA			Enterprise Val	
		Downside	Base	Upside	Downside	Base
Dominion Merchant Generation	376	5.0x	6.0x	7.0x	1,882	2,258
Hedge Value	-	5.0x	6.0x	7.0x	-	-
Dominion Energy (ex-LDCs)	2,186	11.0x	12.0x	13.0x	24,043	26,229
Dominion Midstream Partners	(564)	11.0x	12.0x	13.0x	(6,205)	(6,769)
Dominion Retail	63	4.0x	5.0x	6.0x	251	314
Total / Implied	**2,061**	**9.7x**	**10.7x**	**11.7x**	**$ 19,970**	**$ 22,031**
Dominion Midstream Value						
LP Value						
LP Shares Owned (as of Dec 2016)						50.48
Value per Share (Current Market)						**29.15**
Total Value ($ Mn)						**1,471**
GP Valuation						
NPV Value through 2050 ($ Mn)						**1,336**
Discount Rate (Using CAPM + GP Premium)						*9.3%*
Less Total Dominion Net Debt (2020E)						(36,212)
netting VEPCO-associated debt (Utility Only)						12,020
netting VEPCO debt allocated to HoldCo (assuming lever up to 60% debt/cap)						3,593
netting Gas LDC-associated debt (Holdco Only-STR Gas)						1,400
netting Gas LDC-associated debt (Opco Only-STR Gas)						1,007
netting Gas LDC-associated debt (Opco Only)						1,790
Solar Debt (UBSe)						1,034
Netting DM Debt (2020E)						1,983
Add: NPV of Merchant Generation Hedges						-
Net Energy/Generation Debt						**$ (13,385)**
Dominion Energy, MLP, Merchant Generation, and Retail					**$ 9,392**	**$ 11,453**
Current Number of Shares outstanding (2020E)					620	620
Dominion Energy, MLP, Merchant Generation, and Retail per Share					**$ 15.15**	**$ 18.47**
	Peer P/E Multiple	17.8x	Premium	1.0x		
Dominion Delivery	**2019 NI**	**P/E Multiple**				
Electric	319	17.8x	18.8x	19.8x	5,684	6,003
Transmission	392	17.8x	18.8x	19.8x	6,975	7,367
Dominion Generation-Utility	1,005	17.8x	18.8x	19.8x	17,897	18,903
Total VEPCO Net Income	**1,717**	**17.8x**	**18.8x**	**19.8x**	**30,556**	**32,273**
Value per Share					***$ 49.28***	***$ 52.04***
Gas Distribution LDCs						
Questar Gas (incl. $1.4 Bn HoldCo debt)	54	17.8x	18.8x	19.8x	963	1,018
East Ohio	202	17.8x	18.8x	19.8x	3,603	3,806
Hope Gas	11	16.8x	17.8x	18.8x	178	188
Total Gas Distribution Net Income	**267**	**17.8x**	**18.8x**	**19.8x**	**4,744**	**5,012**
Value per Share					***$ 7.65***	***$ 8.08***
Current Number of Shares outstanding					620	620
Dominion Regulated Utilities SOP Value ($/sh)					**$ 56.93**	**$ 60.13**
Total Equity Value per Share					**$ 72.00**	**$ 79.00**

Source: Company Filings, UBSe

What about HoldCo Debt? Netting out the Utility Debt SOP Scenario

In the scenario below, we net out $1,400 Mn and $3,593 Mn of debt allocated to VEPCO and Questar, respectively, instead of capitalizing it. Accordingly, we are also removing the interest impact from the Utilities net income. As such, our regulated utilities SOP value goes down from ~$60/Sh to ~$55.50/Sh.

Figure 4: SOP Scenario: Netting out net debt

Dominion (D) Sum of the Parts Analysis - UBSe						
	2020E Adj. EBITDA	EV/EBITDA			Enterprise Value	
		Downside	Base	Upside	Downside	Base
Dominion Merchant Generation	376	5.0x	6.0x	7.0x	1,882	2,258
Hedge Value	-	5.0x	6.0x	7.0x	-	-
Dominion Energy (ex LDCs)	2,186	11.0x	12.0x	13.0x	24,043	26,229
Dominion Midstream Partners	(564)	11.0x	12.0x	13.0x	(6,205)	(6,769)
Dominion Retail	63	4.0x	5.0x	6.0x	251	314
Total / Implied	2,061	9.7x	10.7x	11.7x	$ 19,970	$ 22,031
Dominion Midstream Value						
LP Value						
LP Shares Owned (as of Dec 2016)						50.48
Value per Share (Current Market)						29.15
Total Value ($ Mn)						1,471
GP Valuation						
NPV Value through 2050 ($ Mn)						1,336
Discount Rate (Using CAPM + GP Premium)						*9.3%*
Less Total Dominion Net Debt (2020E)						(36,221)
netting VEPCO-associated debt (Utility Only)						12,020
netting VEPCO debt allocated to HoldCo (assuming lever up to 60% debt/cap)						3,593
netting Gas LDC-associated debt (Holdco Only-STR Gas)						1,400
netting Gas LDC-associated debt (Opco Only-STR Gas)						1,007
netting Gas LDC-associated debt (Opco Only)						1,790
Solar Debt (UBSe)						1,034
Netting DM Debt (2020E)						1,983
Add: NPV of Merchant Generation Hedges						-
Net Energy/Generation Debt						$ (13,394)
Dominion Energy, MLP, Merchant Generation, and Retail					$ 9,383	$ 11,444
Current Number of Shares outstanding (2020E)					620	620
Dominion Energy, MLP, Merchant Generation, and Retail per Share					**$ 15.13**	**$ 18.45**
	Peer P/E Multiple	17.8x	Premium	1.0x		
Dominion Delivery	2019 NI	P/E Multiple				
Electric	401	17.8x	18.8x	19.8x	7,139	7,540
Transmission	392	17.8x	18.8x	19.8x	6,975	7,367
Dominion Generation-Utility	1,005	17.8x	18.8x	19.8x	17,897	18,903
Total VEPCO Net Income	1,798	17.8x	18.8x	19.8x	32,011	33,810
Value per Share					*$ 51.62*	*$ 54.52*
Gas Distribution LDCs						
Questar Gas	86	17.8x	18.8x	19.8x	1,530	1,616
East Ohio	202	17.8x	18.8x	19.8x	3,603	3,806
Hope Gas	11	16.8x	17.8x	18.8x	178	188
Total Gas Distribution Net Income	299	17.8x	18.8x	19.8x	5,311	5,610
Value per Share					*$ 8.57*	*$ 9.05*
Holdco Debt Allocated to VEPCO					(3,593)	(3,593)
Questar Holdco Debt					(1,400)	(1,400)
Total HoldCo Debt ($Mn)					(4,993)	(4,993)
Value per Share					*$ (8.05)*	*$ (8.05)*
Current Number of Shares outstanding					620	620
Dominion Regulated Utilities SOP Value ($/sh)					**$ 52.14**	**$ 55.52**
Total Equity Value per Share					**$ 67.00**	**$ 74.00**

Source: Company Filings, UBSe

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UBS Securities LLC: Julien Dumoulin-Smith; Jerimiah Booream

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